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IN THE
Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE NATIONAL ASSOCIATION OF MANUFACTURERS AND THE MANUFACTURERS ALLIANCE/MAPI INC. AS *AMICI CURIAE* SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether, in the case of an affiliated group that files a consolidated return, the existence of a product liability loss under 26 U.S.C. § 172(b)(1)(I)(1988) is determined by comparing (i) the income and expenses of the group as a whole, or (ii) the respective income and expenses of each of its members.

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INTEREST OF THE *AMICI CURIAE*

The National Association of Manufacturers ("NAM") is the nation's oldest and largest broad-based industrial trade association, representing 14,000 member companies and 350 member associations in every industrial sector of the national economy. NAM's mission is to enhance the competitiveness of manufacturers and to improve the living standards of working Americans by advocating a legislative and regulatory environment conducive to national economic growth. Many of NAM's members belong to affiliated corporate groups that file consolidated tax returns, and all of NAM's members have a significant interest in the administration of the tax laws.

The Manufacturers Alliance/MAPI Inc. ("MAPI") is a non-profit research and educational organization representing 450 multinational corporations drawn from a full range of manufacturing industries. For more than 66 years, MAPI's research has contributed to the development of the Internal Revenue Code in areas such as recovery of capital costs, credits, and loss carryovers.

NAM and MAPI (collectively, "amici") submit this *amicus curiae* brief to assist the Court in deciding the manner in which product liability losses are to be computed in the consolidated return context.[1]

STATEMENT

Title 26 U.S.C. § 1501 of the Internal Revenue Code (the "Code") provides that "an affiliated group of corporations" may file "a consolidated return with respect to the income tax

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[1] The United States and United Dominion, Inc. have consented in writing to the filing of this brief. The brief was not authored in whole or in part by counsel for either party. No person or entity, other than the amici curiae or their members, made a monetary contribution to the preparation or submission of this brief.

imposed by chapter 1 for the taxable year in lieu of separate returns." [2] Section 1502 in turn provides that the Secretary of the Treasury "shall prescribe such regulations as he may deem necessary" to determine and collect the income tax of an affiliated group that files a consolidated return. The Secretary has done so. *See* Treas. Reg. §§ 1.1502-1 to 1.1502-100.

This case concerns the application of 26 U.S.C. § 172(b)(1)(I)(1988) [3] to an affiliated group that files a consolidated return. Section 172(b)(1)(I) allows "a taxpayer" to carry back a "product liability loss" for up to 10 years before the year in which the loss is incurred. Section 172(j) defines the term "product liability loss" to mean "the lesser of" the taxpayer's product liability expenses and net operating loss for a particular year.[4]

The precise question presented by this case is whether, when an affiliated group files a consolidated return, § 172 requires a comparison of the product liability expenses and net operating loss of the group as a whole, or, alternatively, of the respective product liability expenses and net operating losses of each of the group's members. The Sixth Circuit

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[2] An "affiliated group" is one or more chains of corporations that are related through stock ownership of a common parent. *See* 26 U.S.C. § 1504.

[3] This case involves 26 U.S.C. § 172 and the consolidated return regulations in effect from 1983 to 1986. *See* United Dominion's Petition For A Writ Of Certiorari 1. The Sixth's Circuit's decision in *Intermet Corp. & Subsidiaries* v. *Commissioner*, 209 F.3d 901 (2000), involved the provisions in effect in 1992. *See id.* at 903. Although § 172 was amended in 1990, the amendment was technical as to the product liability loss subsection, and did not change the meaning of that term.

[4] Product liability expenses are defined by § 172(j)(1) to mean deductible expenses incurred in satisfying or defending product liability claims. "Net operating loss" is defined by § 172(c) to mean "the excess of the deductions allowed by this chapter over the gross income."

adopted the former, "consolidated" approach in *Intermet Corp. & Subsidiaries* v. *Commissioner*, 209 F.3d 901 (2000). The Fourth Circuit adopted the latter, "member-level" approach in this case. *See United Dominion Industries, Inc.* v. *United States*, 208 F.3d 452, 458 (2000), *cert. granted*, 531 U.S. __ (2000). The former, consolidated approach is correct.

SUMMARY OF ARGUMENT

Petitioner correctly argues that, under the text and policy of § 172 and the consolidated return regulations, the "taxpayer" whose product liability expenses and net operating loss are to be compared is the affiliated group, not each of its individual members. When an affiliated group files a consolidated return, the group as a whole is the taxpayer under the Code and the consolidated return regulations. Under those provisions, the group files a single, consolidated return; its tax liability is computed on a consolidated basis, with the corporate tax rate being applied to the total income of the group; its net operating loss is computed on a consolidated basis; and, subject to a limited exception not applicable here, that loss can only be carried back to prior return years by the group as a whole. *See* Treas. Reg. §§ 1.1502-75(a),-2(a),-11, -21(f),-21(a). Moreover, as applied in the consolidated return context, the term "taxpayer" as used in other sections of the Code is generally understood to refer to the group as a whole, rather than to its individual members.

When an affiliated group files a consolidated return, therefore, the calculation of the group's product liability loss involves a comparison of the group's product liability expenses and consolidated net operating loss. The latter item is expressly defined by Treas. Reg. § 1.1502-21(f), making this comparison a straightforward one. In addition, this approach is the only one consistent with the purpose of the consolidated return provisions of the Code, which is to treat

an affiliated group that files a consolidated return as a single business unit.

The contrary, member-level approach advocated by the United States and adopted by the Fourth Circuit is inconsistent with the text of § 172 and the consolidated return regulations. Under that approach, a group's product liability loss is the lesser of the aggregate of its members' product liability *losses* and the group's consolidated net operating loss. Section 172(j), however, requires a comparison of a taxpayer's product liability *expenses* and net operating loss. Product liability losses and product liability expenses are two different things, being separately defined under § 172(j). The member-level approach thus calls for a comparison other than the one specified in § 172(j).

The member-level approach is also incoherent. Because a group's net operating loss is computed on a consolidated rather than individual-member basis, *see* Treas. Reg. § 1.1502-21(f), the proponents of the member-level approach must articulate some measure to serve as the member's "net operating loss" for purposes of the § 172(j) comparison. The United States and the Fourth Circuit sharply disagree as to what this measure should be; and neither of the measures they propose withstand scrutiny.

Finally, the member-level approach is unworkable. It would enmesh taxpayers, the Internal Revenue Service (the "Service") and the courts in complex, subsidiary questions that simply do not arise under the more straightforward approach advocated by Petitioner and adopted by the Sixth Circuit. The most fundamental of these is discussed immediately above—concerning the measure to serve as the member's net operating loss—and even the United States and the Fourth Circuit do not agree on the correct answer. Moreover, the member-level approach would entail significantly increased administrative costs. Under that approach, product liability losses are computed on an

individual-member basis; hence the existence of a product liability loss may depend on whether a particular item of income or expense is attributed to one or another member of the group. Because affiliated groups tend to operate as a single business unit, these are factual questions as to which taxpayers and the Service can and will disagree.

In summary, the consolidated approach is consistent with the text of § 172 and the consolidated return regulations. It is also the simpler approach in practice. The member-level approach, in contrast, is an exercise in judicial legislation. It also presents serious practical difficulties. Thus, the member-level approach should be rejected, and the consolidated approach adopted.

ARGUMENT

WHEN AN AFFILIATED GROUP FILES A CONSOLIDATED RETURN, ITS PRODUCT LIABILITY LOSS UNDER 26 U.S.C. § 172 IS DETERMINED BY COMPARING THE INCOME AND LOSSES OF THE GROUP AS A WHOLE

A. When An Affiliated Group Files A Consolidated Return, The Group Is The Taxpayer

1. *The Consolidated Return Regulations And The Code As Applied In the Consolidated Return Context Treat The Group As The Taxpayer*

Under the Code and the consolidated return regulations, an affiliated group that files a consolidated return computes and pays its tax as a single entity. For example, the tax liability of the group is computed on a consolidated basis rather than apportioned among individual members. *See* Treas. Reg. § 1.1502-2(a) (prescribing formula for "[t]he tax liability of a group"). Accordingly, the group's tax liability is computed by applying the corporate tax rate specified in 26 U.S.C. § 11 to the income of the group. *See* Treas. Reg. § 1.1502-2(a).

The group's income is itself computed on a consolidated basis, *see* Treas. Reg. § 1.1502-11 (prescribing formula for "consolidated taxable income"), as is the group's net operating loss. *See* Treas. Reg. § 1.1502-21(f) (prescribing formula for "consolidated net operating loss"). In addition, subject to an exception not applicable here,[5] the net operating loss of a group as computed under Treas. Reg. § 1.1502-21(f) can only be carried forward or back by the group as a whole, not by its individual members. *See* Treas. Reg. § 1.1502-11(a)(2).

That the group is the taxpayer in the consolidated return context is further demonstrated by the application in that context of other statutory provisions which, like § 172(b)(1)(I), employ the term "taxpayer." For example, the Code provides that "any taxpayer entitled to a 10-year carryback" for product liability losses—which is the very carryback at issue here—may elect to waive the extended carryback for such losses. *See* 26 U.S.C. § 172(j)(3).[6] In the consolidated return context, the uniform practice of the Service has been to treat the *group* rather than the individual members thereof as the "taxpayer" entitled to make this election. *See* I.R.S. Private Letter Ruling ("P.L.R.") 94-44-020 (Aug. 2, 1994); P.L.R. 94-41-020 (July 8, 1994).[7]

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[5] The exception arises in certain cases where a member joined the group during the carryback period for the group's consolidated net operating loss. In such cases, if certain conditions are met, a portion of the group's consolidated net operating loss must be separately apportioned to the member that recently joined. *See* Treas. Reg. § 1.1502-79(a). It is undisputed, however, that no such apportionment is required here.

[6] This provision now appears at 26 U.S.C. § 172(f)(6).

[7] Private letter rulings, technical advice memoranda, general counsel memoranda and field service advice issued by the Service are not used or cited as precedent pursuant to §6110(k)(3), but they are widely relied upon in practice because they "do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686

Similarly, § 172(b)(3) of the Code provides that "any taxpayer" entitled to a 3-year carryback for a net operating loss may elect to waive the carryback. Again, in the consolidated return context, the uniform practice of the Service has been to treat the group as the "taxpayer" entitled to make this election. *See* I.R.S. Technical Advice Memorandum ("T.A.M.") 88-16-002 (Dec. 31, 1987); T.A.M. 84-48-004 (July 31, 1984); T.A.M. 81-45-027 (July 31, 1981); I.R.S. General Counsel Memorandum ("G.C.M.") 39,305 (July 27, 1984).

In addition, § 6501(c)(4) of the Code provides that a "taxpayer" may waive the statute of limitations period for collection of any tax imposed under the Code. Here too, when a group files a consolidated return, the Service treats the group as the taxpayer entitled to make this election. *See* Treas. Reg. § 1.1502-77(a) (subject to limited exceptions not relevant here, the "common parent" acts as agent for all members of the group as to "all matters relating to the tax liability for the consolidated return year").

Thus, under the Code and applicable regulations, the affiliated group and not its individual members is treated as the "taxpayer" in years when the group files a consolidated return. Under § 172(j), therefore, the "taxpayer" whose product liability expenses and net operating loss are to be compared is the group, not its individual members.

As a result, the computation under § 172(j) is a straightforward one: The group's product liability loss is the lesser of its product liability expenses and its consolidated net operating loss as calculated under Treas. Reg. § 1.1502-21(f). *See* § 172(j)(1).

(1962). *See, also, Rowan Cos.* v. *United States*, 452 U.S. 247, 261 n.17 (1981).

2. *The Purposes Of The Consolidated Return Provisions Support Computing Product Liability Losses On A Consolidated Basis*

In addition to being consistent with the relevant statutory and regulatory text, the approach advocated by Petitioner and adopted by the Sixth Circuit is the only one consistent with the purpose of § 1501 and the consolidated return regulations. That purpose is simply to recognize that an affiliated group is in reality a single business unit. Thus, the Senate Finance Committee recommended passage of the earliest predecessor to § 1501 expressly "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and the Government." S.Rept. No. 617, 65th Cong., 3d Sess. 9 (1918); *see also* H.R. Rep. No. 100-391, pt. 2, at 1089 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-704 ("The original justification for the consolidated return provisions of the Code was that individual members of a controlled group of corporations should, as a matter of equity and convenience for both the government and the taxpayer, be taxed as a single business unit"); *Amorient, Inc.* v. *Commissioner,* 103 T.C. 161, 168 (1994) ("[t]he consolidated return provisions were enacted for the purpose of taxing an affiliated group of corporations as a single, economic 'business unit'").

Taxing a group as a single business unit allows the group to blend the income and losses of its individual members. Thus, as the Service itself has recognized, "corporations that file a consolidated return should be able to use each other's losses as if they were divisions of a single corporation rather than separate corporations." *Consolidated Returns—Limitations on the Use of Certain Losses, Deductions and Credits*, 56 Fed. Reg. 4,228 (January 29, 1991).

Allowing an affiliated group to blend the income and losses of its members serves important economic purposes. By rendering more tax-neutral the group's decisions to form

new members or to transfer assets among existing members, the consolidated return provisions allow groups to make such decisions on the basis of economic efficiency rather than tax avoidance. The result is increased productivity, greater profits, and, ultimately, larger tax revenues.

These purposes are directly advanced by applying § 172(j) in the manner urged by Petitioner and adopted by the Sixth Circuit. Under that approach, affiliated groups are free to make economic decisions based on economic criteria, without fear of losing an extended carryback for product liability losses.[8] Moreover, as discussed above, the text of the relevant statutory and regulatory provisions afford no occasion for departure from these policies in applying § 172(j) to a group that files a consolidated return. Thus, as a matter of text and policy, the determination of a group's product liability losses under § 172(j) should be made on the basis of the aggregate product liability expenses and consolidated net operating loss of the group, not of each of its individual members.

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[8] Consider, for example, a corporation with a net operating loss of $1000 and a division that generates positive net income but that incurs product liability expenses of $500. As a single entity, the corporation would be entitled to a $500 carryback for product liability losses (which equals the lesser of the corporation's net operating loss and product liability expenses). Under Petitioner's approach, if the corporation chose to incorporate the division as a separate corporation and to file a consolidated return, it would retain the full $500 carryback for product liability losses, because the § 172(j) calculation would be made by comparing the net operating loss and product liability expenses of the group as a whole. Petitioner's approach therefore does not distort the decision whether to incorporate the division. Under a member-level approach, however, the group would lose the entire carryback because the member incurring the product liability expenses is separately profitable. Accordingly, the member-level approach introduces significant tax distortions into operational decisions.

3. *The United States' Criticisms Of The Consolidated Approach Are Misguided*

The United States has made four principal arguments in litigating this case and *Intermet*, none of which have merit.

a. First, the United States asserts that the term "taxpayer" as used in § 172(b)(1)(I) should be understood to refer to individual members rather than to the group as a whole. In support of this assertion, the United States cites 26 U.S.C. §§ 7701(a)(1) and (14), which state a general rule that the term "taxpayer" "shall be construed to mean and *include* an individual, a trust, estate, partnership, association, company, or corporation." (Emphasis added.) But the United States neglects to cite § 7701(b), which provides that "[t]he terms 'includes' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined." As discussed above, the consolidated return regulations and various statutory provisions as applied in the consolidated return context treat an affiliated group that files a consolidated return as being within the meaning of the term "taxpayer." Moreover, unlike §§ 7701(a)(1) and (14), these provisions are specific to the context of consolidated returns. Consequently, the United States errs in suggesting that §§ 7701(a)(1) and (14) exclude affiliated groups from the meaning of the term "taxpayer" in this context.

In addition, the United States has occasionally, but mistakenly, relied on two cases from this Court in arguing that the group cannot be the taxpayer under § 172(j). The first is *Woolford Realty Co.* v. *Rose*, 286 U.S. 319 (1932). There, the petitioner, Woolford Realty, affiliated with the Piedmont Savings Company in 1927. Piedmont had suffered net losses in 1925 and 1926. Woolford filed a consolidated return in 1927, and sought to carry *forward* Piedmont's pre-affiliation losses to offset Woolford's income in 1927. This Court held it could not, reasoning that Woolford and

Piedmont were separate taxpayers as that term was used in the carry*forward* statute at issue there.

Woolford Realty is distinguishable on factual and legal grounds. First, Woolford and Piedmont were not affiliated during the years in which the losses at issue were incurred. Thus, the two companies were separate taxpayers during those years. The carryforward statute used the term "taxpayer" in reference to the year in which a loss was incurred. *See* 286 U.S. at 326 (statute referred to "'any taxable year . . . in which any taxpayer has sustained a net loss'"). Thus, the Court held, Woolford and Piedmont were separate taxpayers for the purposes of the statute.

Here, in contrast, the members incurring product liability expenses *were* members of the affiliated group during the years in which the expenses were incurred. Section 172, like the carryforward statute in *Woolford Realty*, uses the term "taxpayer" in reference to the year in which a product liability loss is incurred. *See* 26 U.S.C. § 172(b)(1)(I) (referring to "a taxpayer which has a product liability loss . . . for a taxable year"). Thus, the members incurring product liability expenses here were part of the same "taxpayer" for purposes of § 172.

Second, the consolidated return statute in *Woolford Realty* differed fundamentally from the one at issue here. There, the statute imposed a tax "upon the respective affiliated corporations 'on the basis of the income properly assignable to each.' " 286 U.S. at 328 (quoting 26 U.S.C. § 240(b) of the Internal Revenue Code of 1926). By imposing a distinct tax liability on each member of a group, the statute clearly treated each member as a separate taxpayer. Here, in contrast, § 1501 and the consolidated return regulations impose a single, undivided tax liability on the group as a whole. *See* Treas. Reg. § 1.1502-2(a) (prescribing formula for "[t]he tax liability of a *group*") (emphasis added).

Consequently, § 1501 and the regulations treat the group as the taxpayer.

The United States likewise errs in relying upon *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). There, Uly Thompson, who was the majority shareholder of Moline Properties, Inc. ("Moline"), argued that the income from a sale by Moline to a third party should have been attributed directly to Thompson for tax purposes. This Court disagreed, holding that the corporation was separate from its shareholder for tax purposes as for others. The case did not involve the filing of a consolidated return, however, and thus did not address the issue whether an affiliated group is a taxpayer when it files such a return.

b. The United States' second criticism of the consolidated approach concerns the computation of "separate taxable income" under Treas. Reg. § 1.1502-12. Under this regulation, a member's separate taxable income "is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations," subject to substantial modifications. *Id; see also infra,* at 18-19. Product liability expenses are considered in determining a member's separate taxable income. *See* Treas. Reg. § 1.1502-12. Accordingly, the United States argues that such expenses are "absorbed" in cases where the member has positive separate taxable income; and this, according to the United States, precludes a product liability loss for such expenses under § 172(j)(1).

This is an argument more metaphysical than legal. Under the text of the regulations, separate taxable income is merely an intermediate calculation made in computing the consolidated taxable income and consolidated net operating loss of the group. *See* Treas. Reg. § 1.1502-11(a)(1) (setting forth multi-step formula for computing consolidated taxable income); Treas. Reg. § 1.1502-21(f) (setting forth similar formula for computation of consolidated net operating loss).

No tax is imposed on "positive" separate taxable income, and "negative" separate taxable income cannot be carried back to offset income in prior tax years. To the contrary, tax is imposed only on consolidated taxable income, and only consolidated net operating losses can be carried back to prior tax years. *See* Treas. Reg. §§ 1.1502-2(a), 1.1502-21.

Thus, as the Sixth Circuit correctly observed, separate taxable income "has no independent significance"; rather, it "is simply a step along the way to calculating a group's taxable income or [consolidated net operating loss]." *Intermet,* 209 F.3d at 906. By arguing that product liability expenses are somehow "absorbed" by positive separate taxable income, the United States assigns separate taxable income a significance it lacks under the text of the regulations.

c. Third, the United States asserts that product liability losses are not among the deductions that Treas. Reg. §§ 1.1502-22 to -27 expressly direct to be computed on a consolidated basis. From this the United States infers that product liability losses should be computed on an individual-member basis. The sections of the Code that authorize these deductions, however, differ in a critical respect from § 172(j). Those sections explicitly or implicitly make the referenced deductions available to "a corporation," which term arguably does not encompass an affiliated group.[9] Thus, absent an

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[9] *See* Treas. Reg. § 1.1502-22 (concerning 26 U.S.C. § 1211(a) limitation on the capital losses of "a corporation" and 26 U.S.C. § 1212(a) capital loss carryback of "a corporation"); Treas. Reg. § 1.1502-23 (concerning 26 U.S.C. § 1231 gains and losses); Treas. Reg. § 1.1502-24 (concerning charitable contribution deduction of "a corporation" under 26 U.S.C. § 170(b)(2)); Treas. Reg. § 1.1502-25 (concerning 26 U.S.C. § 922 deduction for a "Western Hemisphere Trade corporation"); Treas. Reg. § 1.1502-26 (concerning dividends received deduction allowed to "a corporation" under 26 U.S.C. §§ 243(a)(1), 244(a) and 245); and Treas. Reg. § 1.1502-27 (concerning 26 U.S.C. § 247 limitation on deductions of dividends paid by a public utility, which is "a corporation").

express regulatory directive to compute these deductions on a consolidated basis, they arguably would have to be computed on an individual-member basis. *Cf. First Chicago NBD Corporation* v. *Commissioner*, 135 F.2d 457 (CA7 1998) (refusing to permit aggregation of stock ownership by an affiliated group for purposes of § 902 foreign tax credit because § 902 refers to "a corporation").

Section 172(j) in contrast, uses the term "taxpayer," which does encompass an affiliated group that files an consolidated return. Thus, unlike the deductions discussed above, there is no textual inference that product liability losses must be computed on an individual-member basis. Accordingly, they can be computed on a consolidated basis.[10]

d. Finally, the Service has argued in prior briefs, and the Fourth Circuit reasoned in this case, that computing product liability losses at the group rather than the member level would create a "windfall" for the group. *United Dominion*, 208 F.3d at 458. The assumption here—and it is one that

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[10] There is a simple factual explanation for the composition of the list of deductions cited by the United States (which is set forth in Treas. Reg. §§ 1.1502-22 to -27). The consolidated return regulations, including the list cited by the United States, were first promulgated in 1966. Product liability losses were not on the original list because they did not exist at that time. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 371 (creating carryback for product liability losses). The Service has been exceedingly slow to update the list, which is shown by the fact that certain items on it reflect provisions of the Code that have since been modified or repealed. *See, e.g.*, Treas. Reg. § 1.1502-24 (1998) (limiting charitable deductions to five percent of adjusted consolidated taxable income, although Congress increased this percentage to 10 in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 263); Treas. Reg. § 1.1502-26 (1998) (providing for 85% "dividends received" deduction, although Congress reduced this percentage to 70 in the Revenue Act of 1987, Pub. L. No. 100-203, § 10221(a)(1)). Thus, the fact that product liability losses are not on the list cited by the United States is of little or no probative significance.

underlies the entirety of the United States' position in this case—is that, if a member would not have had a product liability loss on a separate return, then the group cannot have such a loss on a consolidated return. But the tax that a group's members would have incurred had they filed separate returns cannot be the measure of the tax that a group should incur in filing a consolidated return. If it were, there would be no reason to file a consolidated return. Indeed, the very purpose of the consolidated return provisions is to permit an affiliated group to blend the losses and income of its individual members, a blending that will almost always affect the amount of tax paid by the group. Thus, by incorrectly assuming that § 1501 and the consolidated return regulations must yield a result equivalent to that reached pursuant to the filing of separate returns, the Service and the Fourth Circuit would do much to render those provisions a nullity.

B. The Member-Level Approach Is Unsound And Unworkable

1. *The Member-Level Approach Is Contrary To The Text Of § 172(j)*

The position of the United States and the Fourth Circuit is contrary to the plain text of § 172(j). As noted above, § 172(j) provides that a taxpayer's product liability loss is equal to the lesser of the taxpayer's product liability expenses and net operating loss. Under the consolidated approach advocated by Petitioner and adopted by the Sixth Circuit, this computation involves a straightforward comparison of the group's aggregate product liability expenses and consolidated net operating loss as calculated under Treas. Reg. § 1.1502-21(f). This approach thus involves a comparison of the very items specified in § 172(j).

The same is not true of the member-level approach. Under that approach, "each member must initially compute its product liability loss (if any) on an individual basis." Brief

12. These individual product liability losses are then aggregated and compared to the consolidated net operating loss of the group, with the group's product liability loss equaling the lesser of those two amounts. *Id.;* T.A.M. 9715002 (Dec. 12, 1996). The group's product liability loss, therefore, is the lesser of the aggregated individual product liability *losses* and the group's consolidated net operating loss.

This is not the comparison mandated by § 172(j)(1). That section states that a taxpayer's product liability loss is the lesser of the taxpayer's net operating loss and the taxpayer's product liability *expenses*, not the taxpayer's product liability *losses*. Product liability expenses, which are defined by § 172(j)(1)(B), are very different from product liability losses, which are separately defined in § 172(j)(1). The Fourth Circuit itself recognized this difference, though it failed to modify its analysis accordingly. *See United Dominion*, 208 F.3d at 458 ("the tax regulations plainly provide the ten-year carryback only for 'product liability *loss*' (and not for product liability *expense*)") (emphasis added). The member-level approach thus constitutes a clear departure from the text of § 172(j), and for that reason should be rejected.

2. *The Member-Level Approach Is Incoherent*

As noted above, § 172(j) requires a comparison of a taxpayer's product liability expenses and net operating loss. When an affiliated group files a consolidated return, the net operating loss for the group is calculated on a consolidated basis. *See* Treas. Reg. § 1.1502-21(f). Thus, the member-level approach raises the question of what is to serve as the "net operating loss" for purposes of calculating the individual product liability loss of a member of a group that files a consolidated return.

The United States and the Fourth Circuit offer different answers to this question.[11] The United States argued in the Fourth and Sixth Circuits that a member's "separate taxable income" under Treas. Reg. § 1.1502-12 should serve as the equivalent of a net operating loss for computing the member's product liability loss. *See United Dominion*, 208 F.3d at 459; *Intermet*, 209 F.3d at 906. Thus, according to the United States, a member's product liability loss is the lesser of its "negative" separate taxable income and its product liability expenses.[12]

The Fourth Circuit expressly rejected the United States' argument concerning the use of a member's separate taxable income in computing the member's product liability loss. *United Dominion*, 208 F.3d at 459. Instead, the Fourth Circuit concluded, the member's "separate net operating loss," computed under Treas. Reg. § 1.1502-79(a)(3), should be used instead. Thus, according to the Fourth Circuit, a member's product liability loss is the lesser of its "separate

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[11] The United States seeks to avoid discussion of this question by dismissing it as "irrelevant to the legal issue presented by this case." Brief For The United States On Petition For A Writ Of Certiorari 13, n. 12. Whether the details of the member-level approach to calculating a group's product liability loss render that approach unworkable, however, certainly is relevant to whether the approach should be adopted. This point is demonstrated by the fact that the Fourth Circuit devoted the better part of its analysis to the very question the United States now seeks to avoid. *See United Dominion*, 208 F.3d at 459-461.

[12] The Service has adopted "shifting and incongruous reasoning" as to the measure used for computing a member's product liability loss, with the formula quoted in the text being only the latest iteration thereof. *See Intermet*, 209 F.3d at 908. Consequently, the Service's position in this case is entitled to little if any deference. *See, e.g., I.N.S.* v. *Cardoza-Fonseca*, 480 U.S. 421, 446 n. 30 (1987) ("An agency interpretation of a relevant provision which conflicts with the agency's earlier interpretation is 'entitled to considerably less deference' than a consistently held view") (quoting *Watt* v. *Alaska*, 451 U.S. 259, 273 (1981)).

net operating loss" and its product liability expenses. *Id.* at 461.

a. Neither of the measures proposed by the United States or the Fourth Circuit withstand scrutiny. The United States errs in arguing that a member's separate taxable income is the equivalent of its net operating loss for purposes of computing its product liability loss. On this point there is no circuit split. *See United Dominion*, 208 F.3d at 460 (expressly "reject[ing] the IRS's proposed reference to the member's 'separate taxable income' in the determination of whether the member's product liability expenses are 'product liability loss'"); *Intermet*, 209 F.3d at 907 ("reject[ing the Service's] analysis" regarding separate taxable income).

There are good reasons for this consensus among the circuits. First, the United States' position on this point is clearly at odds with the text of § 172(j) and the consolidated regulations. As discussed *supra* at 12-13, a member's separate taxable income is merely one component in the formula for calculating a group's consolidated taxable income and consolidated net operating loss under Treas. Regs. §§ 1.1502-11 and - 21(f). Accordingly, a member's separate taxable income is something quite different from a net operating loss as defined by § 172(c) or Treas. Reg. § 1.1502-21(f). Thus, just as the United States advocates a comparison of items other than those specified in § 172(j) in computing a *group's* product liability loss, *see supra* at 15-16, so too the United States advocates a comparison of items other than those specified in that section in computing a *member's* product liability loss. Its position, in short, is altogether unmoored from the statutory text.

The United States' position makes little sense even if one accepts the mistaken premise that underlies it, namely, that if a member would not have had a product liability loss on a separate return, then the group cannot have such a loss on a consolidated return. Under Treas. Reg. § 1.1502-12, a

member's separate taxable income does *not* include certain income and deductions that *would* be included on a member's separate return. These include, for example, charitable deductions and capital gains and losses. *See* Treas. Reg. § 1.1502-12(l), (j). This was a point that the Fourth Circuit emphasized at some length. *See United Dominion,* 208 F.3d at 459 (stating that "we agree" with the taxpayer's assertion that "'separate taxable income' by definition excludes income and deductions that would be incorporated in calculating the group member's taxable income or net operating loss, if the group member had filed a separate tax return"); *see also id.* at 456.

Thus, as the United States concedes in its brief, "[i]t is possible for a corporation to compute positive separate taxable income [thus precluding a product liability loss under the United States' theory] even though the corporation would have reported a net operating loss had it filed a separate return." Brief For The United States On Petition For A Writ Of Certiorari 11, n. 9. "Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income had it filed a separate return." *Id.*

The use of separate taxable income in determining a member's product liability loss, therefore, yields results that are "flatly contrary to the separate tax return analogy from § 172(j)." *United Dominion,* 208 F.3d at 459. Thus, even if one makes the mistake of accepting that analogy, the measure proposed by the United States can only be regarded as arbitrary.

b. The measure proposed by the Fourth Circuit fares little better. As noted above, the Fourth Circuit held that a member's "separate net operating loss" under Treas. Reg. § 1.1502-79(a) should be used in computing the member's individual product liability loss under § 172(j). By its terms, however, Treas. Reg. § 1.1502-79(a) governs only the

question whether a portion of a group's consolidated net operating loss (as computed under Treas. Reg. § 1.1502-21(f)) must be "apportioned" to an individual member that filed a separate return during the carryback period for the loss.

Here, it is undisputed that Treas. Reg. § 1.1502-79(a) does not require any portion of Petitioner's consolidated net operating loss to be apportioned to a "separate return year," Treas. Reg. § 1.1502-1(e), of any of its members. The Fourth Circuit simply invented a measure for computing a member's product liability loss that has no support in the text of the regulations. As the Sixth Circuit observed in reaching its contrary conclusion: "The [Fourth Circuit] offered no analysis to support its conclusion that [Treas. Reg. § 1.1502-79(a)(3)] dictates a method for calculating a member's 'separate net operating loss' outside of the separate return context." *Intermet*, 209 F.3d at 908.

The Fourth Circuit is also incorrect in suggesting that a member's separate net operating loss under Treas. Reg. § 1.1502-79(a) is identical to the net operating loss that a member would compute on a separate return. Under Treas. Reg. § 1.1502-79(a)(3), the formula for computing a member's separate net operating loss makes no reference to the net operating loss that a member might compute on a separate return. Those computations, therefore, are likely to yield differing amounts.

The misguided nature of the Fourth Circuit's analysis—and the overwhelming complexity of the member-level approach to computing product liability losses—is further shown by the fact that the Court confused the very measure it invented. As noted above, the Fourth Circuit held that a member's product liability loss is the lesser of its product liability expenses and "separate net operating loss" as computed under Treas. Reg. § 1.1502-79(a). That regulation requires two separate computations in cases where it applies: First, a computation

of a member's separate net operating loss;[13] and second, a computation of the amount, if any, of the group's consolidated net operating loss that must be apportioned to a member that files such a return.[14]

Here, it is unclear which computation the Fourth Circuit meant to use. On the one hand, the Court asserted that a member's product liability loss should be calculated "[b]y comparing [its] product liability expenses to its 'separate net operating loss[.]'" 208 F.3d at 460. This comparison would utilize the separate net operating loss computation. But, on the other hand, the Court stated that "application of th[e] *apportionment* formula to the issue in this case results in logical consistency of the general consolidated return framework, and the specific resolution of the issue in this case." *Id.* (emphasis added); *see also id.* at 460 n. 16 (quoting the apportionment computation). This statement suggests that a member's product liability expenses should be compared to its *apportionment* computation.

But the critical point for this case is not which of the computations should have been used below; neither should have been used, since the member-level approach should be rejected *simpliciter*. The critical point, rather, is that the Fourth Circuit invented a measure which reflects the confusion inherent in the member-level approach. This is reason enough to reject the member level approach.

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[13] The separate net operating loss of a member that files a separate return during the carryback period is the member's separate taxable income plus a portion of certain deductions, losses, and income of the group. Treas. Reg. § 1.1502-79(a)(3).

[14] This amount is "equal to the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of [the member that filed the separate return during the carryback period], and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses." Treas. Reg. § 1.1502-79(a)(3).

3. *The Member-Level Approach Is Unworkable*

a. The member-level approach would enmesh taxpayers, the Service, and the courts in difficult, subsidiary questions that do not arise under Petitioner's approach. One such question is discussed above, concerning the measure used in computing a member's product liability loss. That the United States and the Fourth Circuit pointedly disagree on the answer to this question—and that each of their answers is wrong—is a clear indication of the difficulties that attend their approach.

Another abstruse question that arises under the member-level approach—but not Petitioner's—concerns the computation of the group's product liability loss after the members' individual product liability losses are computed. As noted previously, § 172(j)(1) states that a taxpayer's product liability loss is the lesser of its net operating loss and its product liability expenses. This is known as the "stacking rule," because its effect is to offset the taxpayer's income with product liability expenses only after all other deductions are absorbed by income. For example, if a taxpayer has $300 of income, $100 of product liability expenses, and $300 of other (*i.e.*, non-product liability) deductions, the stacking rule ensures that the other deductions are used to offset income, and that the entire $100 of product liability expenses remains available for the extended, 10-year carryback.

The application of the stacking rule under the member-level approach is arguably uncertain. As shown above, the stacking rule applies through the device of comparing the taxpayer's net operating loss and product liability expenses. As noted *supra* at 15-16, however, the member-level approach departs from the text of § 172(j)(1) by requiring a comparison of the group's consolidated net operating loss and the aggregate of the members' product liability *losses*, rather than product liability *expenses*, as specified in § 172(j)(1).

This takes the computation of the group's product liability loss out of the literal scope of the stacking rule.

The question thus arises whether this computation should nonetheless be guided by the stacking rule. If so, the group's product liability loss would be the lesser of its net operating loss and the aggregate of the members' product liability losses. If not, the members' product liability losses might offset the income of the group's members on a proportionate basis.

To appreciate the difference between these approaches, consider a group with two members having aggregate product liability losses of $500, another member having $2000 of income, and a fourth member having $2000 of other deductions during a consolidated return year. Under the stacking rule—according to which product liability losses are "used last" to offset member income—the other deductions alone would fully offset the third member's income, leaving a product liability loss for the group of the full $500. But under the proportionate approach, the product liability losses would offset income commensurate with their share of the total losses of the group's members. In this example, product liability losses comprise one-fifth of the group's total losses. Thus, for every four dollars of other deductions used to offset member income, one dollar of product liability losses would be so used. Accordingly, under the proportionate approach, the group would be left with a product liability loss of only $100 after its income is offset.

Amici believe it is clear that the stacking rule should always apply in computing product liability losses. Section § 172(j)(1) reflects a clear policy that product liability losses be preserved to the greatest possible extent in offsetting taxpayer income. To disregard that policy because of the member-level approach's departure from the statutory text is

only to compound the error of departing from the text in the first place.[15]

But the critical point for this case is that Petitioner's approach avoids all these questions. By using the text and policy of the Code and regulations as its guide, Petitioner's approach avoids the dense undergrowth of subsidiary issues raised by the member-level approach.

b. The member-level approach would also entail significantly increased administrative burdens. In addition to creating legal disputes of the sort described above, the member-level approach would multiply the factual disputes between taxpayers and the Service under § 172(j). It would do so because the location of assets and the origin of losses within a group would matter. If the § 172(j) comparison of product liability expenses and net operating loss is to be made at the individual-member level, the existence of a product liability loss – and thus the availability of the extended 10-year carryback—may well depend on whether a particular item of income, or a particular liability loss, is attributed to one or another member. Because affiliated groups generally operate as a single business unit, these are questions as to which taxpayers and the Service can and will disagree.

In contrast, under Petitioner's approach, these questions do not arise because the location of assets or origin of losses within the group generally will not affect whether the group has a product liability loss. For this reason as well, then, the

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[15] In addition, Treas. Reg. § 1.1502-21(b)(1), which governs the carryback of a group's consolidated net operating loss (of which its product liability loss is a part) states that the carryback of a consolidated net operating loss is determined "under the principles of § 172(b)." Section 172(b)(1)(I), which authorizes the 10-year carryback for product liability losses, in turn expressly refers to § 172(j), which contains the stacking rule.

member-level approach should be rejected, and Petitioner's approach adopted.

CONCLUSION

The judgment of the Fourth Circuit should be reversed.

Respectfully submitted,

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